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UNCLAS SECTION 01 OF 03 MEXICO 004970

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TREASURY FOR IA (ALICE FAIBISHENKO)
DOE FOR INTERNATIONAL AFFAIRS KDEUTSCH AND ALOCKWOOD
NSC FOR RICHARD MILES, DAN FISK
STATE PASS TO USTR (EISSENSTAT/MELLE)
STATE PASS TO FEDERAL RESERVE (CARLOS ARTETA)

E.O. 12958: N/A
TAGS: ECON ELAB EFIN PINR PGOV MX
SUBJECT: MEXICO'S TAX REFORM BILL NEARING ADOPTION

REF: A. MEXICO 4815
¶B. MEXICO 4552
¶C. MEXICO 4282
¶D. MEXICO 4280
¶E. MEXICO 4236
¶F. MEXICO 4191
¶G. MEXICO 4151
¶H. MEXICO 4015
¶I. MEXICO 3246
¶J. MONTERREY 725

Summary and Introduction

¶1. (SBU) President Calderon's economic team and political parties, mainly the National Action Party (PAN) and the Institutional Revolutionary Party (PRI), have reached a consensus on almost all issues included in the tax reform bill. Legislators in the finance committee of the Chamber of Deputies discussed and approved on September 12 the seven bills included in the fiscal reform. With some changes, the tax reform aims to increase federal tax collection by 2.5 percent of GDP by 2012 and at least USD 9 billion in 2008. The tax reform bill could be adopted as early as September 13 in the Chamber of Deputies. The bill had been put off until political parties had reached agreement on an electoral reform bill being discussed at the same time in the Senate. The electoral reform bill was approved on September 12 in the Senate (it now faces a vote in the Chamber of Deputies), opening the way for approval of tax reform. Although it is a step in the right direction, the tax proposal is not the bold reform needed to fully address Mexico's low level of tax collection and declining oil production. End Summary.

Congress' Proposal and Changes

¶2. (U) The Calderon government's fiscal reform proposal

remains centered on a new alternative minimum tax designed to prevent companies from using deductions and loopholes to significantly reduce their tax payments. The original alternative minimum tax, (CETU, Single Rate Business Contribution) has been modified, and is now called the Single Rate Business Tax (IETU) because legislators believe it is more appropriate to call it a tax, rather than a contribution. Ministry of Finance Under Secretary Alejandro Werner has told Econoffs that he believes the modified IETU tax would be creditable against U.S. taxes. Mexico's legislators have said the Calderon Administration would be responsible for getting other countries to accept the creditability of the IETU under tax treaties.

¶3. (U) As originally proposed, the CETU rate would have been 16 percent in 2008 and 19 percent starting in 2009. However, to sooth private sector concerns, legislators agreed to reduce the IETU to 16.5 percent in 2008, and gradually increase it to 17 percent in 2009, and 17.5 percent in 2010. The private sector is still calling for the tax to be reduced to 16 percent.

¶4. (U) Addressing industry and maquila concerns about hurting job creation, Congress also proposed allowing deductions for salaries and other labor costs, such as fees for social security. Investments made during the last quarter of 2007 will also be deductible for the next three years. A transition period for fixed assets' amortization was also approved.

¶5. (U) Calderon's original proposal included a 2-percent levy on monthly cash bank deposits of more than 20,000 pesos (USD 1,835) -- a tax that can be credited against income taxes --

and measures to fight tax evasion. Legislators raised the monthly threshold on cash deposits to 25,000 pesos (USD 2,230). To allow banks to prepare their systems to be able to collect the tax, the measure will not be effective until July 1, 2008. Legislators agreed to keep the government's proposal to introduce a 20-percent tax on lotteries and gambling-related income, but discarded the 50-percent tax on aerosol paints. The Congress also met public concerns by allowing tax deductions for charitable donations -- with some restrictions to prevent companies from using this as a mechanism for tax evasion -- and deductions for small agricultural producers.

Complying With Political Commitments

¶6. (U) The legislature has dropped Calderon's proposal to grant states the authority to collect local taxes on tobacco, gasoline, and beer, because governors did not want to assume the political cost of directly collecting those taxes. The Institutional Revolutionary Party (PRI) and the National Action Party (PAN) agreed on a 5.5-percent increase in gasoline prices, which would be collected by the federal government. Additional resources obtained from the gas tax hike would be completely transferred to the states and municipalities provided they sign an agreement with the federal government, in which they commit to use the resources for infrastructure projects. Legislators agreed to increase gasoline prices gradually and include a subsidy for the ten poorest states. The proposal approved on September 12 provides for an increase in the price of gasoline by 2 cents each month over an 18-month period making for a 36 cent increase at the end of this period in order to reduce the expected 0.3-percent inflationary impact. Some PRI and PAN lawmakers were reluctant to approve the gas tax increase, but providing the additional revenue to local governments was a commitment made to get governors to support tax reform. The Democratic Revolution Party (PRD) legislators have already announced that they will vote against a gas price increase out of stated concern over the impact on the lower class.

¶7. (U) Concurrent with giving the states more revenue was the desire of the Calderon Administration to make the states more accountable for how they spend government funds. Under the new proposal, Congress' Fiscal Auditor is given more power to audit transfers of federal resources to the states. To make overall government spending more efficient, opposition legislators introduced a proposal to lower the government's current expenditures by 20 percent during Calderon's term, 5 percent every year, in addition to the USD 933 million proposed by the government in its 2008 budget package.

¶8. (U) The PAN and PRI included a proposal previously made by the PRD to levy company acquisitions through the Mexican Stock Market, which are currently tax exempt.

¶9. (U) The Congress is agreeing with Calderon's effort to give more teeth to the Tax Administration System (rough equivalent of the IRS) to fight tax evasion. The current legislation raises sanctions on accountants who promote tax evasion.

¶10. (U) Congressional approval of Calderon's tax reform proposal, was made subject to the passage of a PRI proposal to reform Pemex's "tax system," i.e. the amount of Pemex revenue going directly to the government. On September 11, legislators approved a new tax regime for the state-run company, which would provide allow it to keep an additional USD 2.7 billion in 2008 and up to USD 5 billion by 2012. Legislators will earmark these additional resources so that Pemex invests them in increasing its production and research, rather than for current expenditures. The reform is expected

to help Pemex increase its production to 200,000 of barrels a day by 2010 or 2011. The tax paid by Pemex to the government will decrease from 78 percent to 71.5 percent over a five year period.

Proposal Nearing Adoption

¶11. (SBU) Fiscal reform could be approved by the Chamber of Deputies as early as this week and passed to the Senate for a vote next week. Although Calderon's 2008 budget proposal did not include additional revenue from tax reform, the Chamber could still approve tax reform before the October 20 deadline for passing the revenue component of the budget (the "Revenue Law"). The Finance Secretariat is working with Congress to amend the proposed 2008 budget to reflect changes in government revenue made by legislators.

Comment

¶12. (SBU) The process of building consensus with different political forces, governors, and the private sector proved difficult, especially when opposition legislators linked tax and electoral reform. Given Congress' composition, Calderon needed PRI support to pass the tax reform bill which has long been his priority. The PRI finally supported the tax reform, although with changes to the initial proposal. Interestingly, many of the PRI's changes resolved concerns registered by the Mexican and international business community. On a broader level, the PRI seems to understand that if it wants to contend for the 2012 presidential elections, it needs to project an image of itself as party working for constructive reform as opposed to a party blocking such efforts. The PRI also seems to appreciate the wisdom of addressing existing pressures on public finances now rather than facing them in 2012.

¶12. (SBU) The bill heading for adoption does not levy taxes food and medicine or cut back on generous special tax

regimes, and it is not the bold reform many had hoped for. It is a step forward, however, and will help reduce pressure on public finances, channel resources to the federal government's priorities, and give Calderon more credibility regarding his power to achieve political consensus. However, a second generation of reforms will be needed to address the expected 3.3 percent of GDP deficit in 2012 and channel more resources to social development, infrastructure, and sustained growth. End Comment.

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